



Listed Issuer Regulation Newsletter

Highlights

- Auditing, financial reporting and related internal control matters
- Compliance with new Rules on share schemes
- Disclosure of business valuations in transactions
- HKEX's ongoing journey in application of technology

Welcome to the June 2023 edition of HKEX's Listed Issuer Regulation Newsletter. Published on a semi-annual basis, this newsletter aims to keep you updated on issuer-related regulatory developments and support you on your compliance journey.

Auditing, financial reporting and related internal control matters

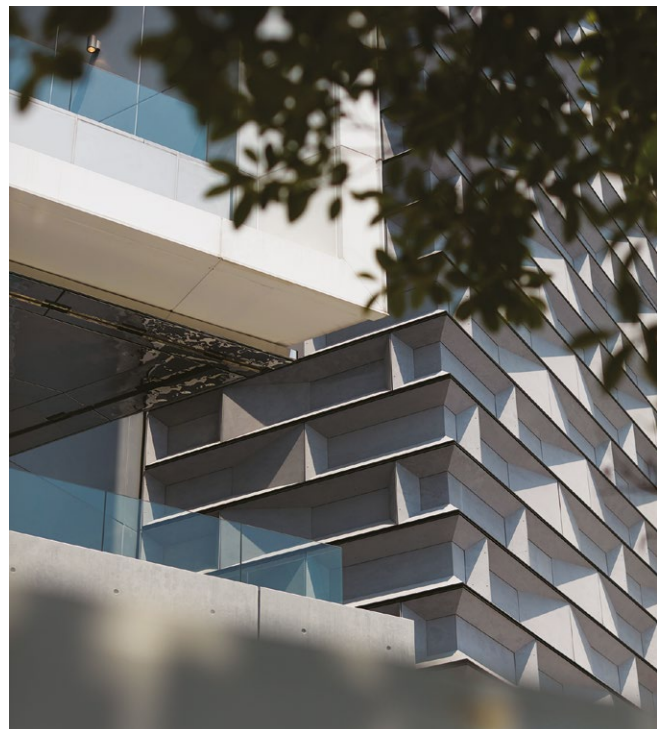
Timely publication of quality financial reports is critical to an informed and efficient market. This March, 59 issuers failed to publish annual results as agreed with auditors by the deadline, and 88 issuers¹ received a modified audit opinion from auditors representing 3% and 5% respectively, out of approximately 1,900 issuers with a December financial year-end.

In our December 2022 [Newsletter](#), we highlighted audit committees' role in overseeing the audit process. We also identified some issues related to late changes in auditors and advised audit committees to make appropriate enquiries with the outgoing and incoming auditors. We continued to identify late changes in auditors and in recent months, around 60 issuers² changed their auditors within four months from the deadline for financial reporting.

Change in auditors

In our review of issuers' announcements on changes in auditors, we identified the following issues:

- In order to complete the audit as soon as practicable, the issuers decided to appoint new auditors despite the fact that audit issues were identified by the outgoing auditors. However, the issuers' initial announcements failed to explain why a change in auditors could expedite the audit process or resolve the audit issues, and failed to disclose the role of their audit committees and the actions they had taken in relation to the audit process or the auditor change. We expect audit committees to follow our guidance³ as shared in our December 2022 [Newsletter](#), where we noted that during such processes, issuers are required to make adequate disclosure in their announcements.
- Audit fee disagreement remains one of the main reasons leading to late auditor's resignation. Audit committees should monitor the timing of issuers' audit fee discussion with auditors to mitigate the likelihood of late auditor change, as allowing sufficient time for auditors to plan and conduct an audit is one of the key factors to achieve a quality audit.



¹ In comparison, 35 and 68 issuers with December financial year ends failed to publish annual results agreed with auditors by the deadlines in 2022 and 2021, and 97 and 101 issuers received a modified audit opinion from auditors in 2022 and 2021.

² These issuers have December financial year ends and exclude long-suspended issuers.

³ Audit committees should, among others, understand clearly the reasons that led to outgoing auditors' resignation, critically review the capabilities and resources of the incoming auditors to perform a quality audit, and ensure the incoming auditors are fully aware of the outgoing auditors' resignation reasons and have an audit plan to address all unresolved issues

Modified audit opinions and delays in results publication

Based on issuers' announcements, audit modifications and delays in financial reporting in most cases were resulted from issuers' inability to provide all books and records, insufficient audit evidence and information available to auditors, or irregularities in transactions uncovered by auditors. As of the end of May, over 40 issuers were still unable to publish their accounts and remained suspended.

We urge these issuers and their audit committees to pay particular attention during the audit progress. Audit committees should understand the nature and root cause of the outstanding matters, facilitate management and auditors to agree on a plan and timeline to resolve the issues, conduct regular meetings with them to monitor the progress, and step in when there is a delay or deviation from the plan.

To different extents, these issues are attributable to deficiencies in internal controls including, among others, lack of management oversight, poor and late audit planning, and inadequate human resources allocated to the financial reporting functions. We reiterate that issuers' boards should build and maintain strong compliance culture and mentality throughout the organisation and devote sufficient resources (including staffing, systems as well as management attention and priority) to their financial reporting functions.

In light of the above, audit committees' actions in relation to auditor change and effectiveness of issuers' internal control systems will be our main focus in monitoring issuers' Rule compliance this year. Issuers should identify internal control deficiencies and take appropriate remedial measures to strengthen their internal control systems.

Compliance with new Rules on share schemes

Effective 1 January 2023, Chapter 17⁴ was amended to govern both share option schemes and share award schemes of listed issuers and their principal subsidiaries. In our pre-vetting of shareholder circulars, we have noted some common pitfalls as described below:

Amended Rules

- Vesting period – Under Main Board Rule 17.03F/ GEM Rule 23.03F, any options or awards granted must be subject to a minimum vesting period of 12 months, unless the grants are made to employee participants under specific circumstances set out in the scheme document.

FAQ No. 092-2022 sets out examples where the Exchange may consider as justifiable circumstances, e.g. grants of “make-whole” awards to new joiners to replace the awards forfeited, grants to a participant whose employment is terminated due to death or disability or occurrence of any out of control event, and grants with performance-based vesting conditions in lieu of time-based vesting criteria.

- Performance targets – Main Board Rule 17.03(7)/ GEM Rule 23.03(7) requires a scheme document to provide a description (which may be qualitative) of the performance targets attached to the options or awards to be granted, or a negative statement. This may include a general description of the target levels and performance related measures and the method for assessing how they are satisfied.

Observed pitfalls

- The circumstances cited by some issuers for a shorter vesting period were generic and did not meet the Rule requirement, for example:
 - “any circumstances as the board considers appropriate at the time of grant” - This lacked specific criterion to assess a shorter vesting period.
 - “circumstances to recognise the past performance of the employees” - The suggested circumstances to recognise “past performance” do not support the purpose of share schemes, which is to incentivise the grantees to contribute to the long term growth of the issuer.
- The description of performance targets in some scheme documents was generic and did not set out the criteria for assessing if the performance targets would be met, for example:
 - “the vesting of the options granted is subject to satisfactory performance of the employee participant”.

⁴ GEM Rules Chapter 23

Disclosure of business valuations in transactions

In a notifiable transaction, the Rules require issuers to disclose the basis for the consideration and the terms of the transaction⁵. While the Rules do not generally require an independent business valuation to support the consideration agreed by the issuer, our [Frequently Asked Question Series 7](#) No. 21 requires that, where the valuation of a target company is a primary factor in forming the basis for the consideration or other material terms of a notifiable transaction, disclosure of the valuation would need to be made in the relevant announcement and circular. Further, the general standard for disclosure requires that information contained in issuers' documents must be accurate and complete in all material respects and not be misleading or deceptive.

In our vetting of issuers' transaction announcements, we are particularly focused on transactions where we are concerned whether the terms of the transaction (including the consideration) are fair and reasonable to the issuer and its shareholders as a whole. In our observation, the disclosure in these issuers' documents were overly general and simplistic. While the basis for the consideration for these transactions was primarily based on independent valuations, the disclosure about the valuation fell short of information that was necessary for investors to understand the underlying valuation methods and assumptions, bases for adopting them, and how the valued amount was derived.

Given this, we find it beneficial to highlight some general principles for disclosure of valuation:

A. Selection of valuation methods

1. Issuers should describe the selected valuation models and explain why they are selected, in particular why the methods were appropriate for the transactions or the target companies. For example:
 - When applying the discounted cash flows (DCF) method to value a start-up target company, issuers should explain how the use of the DCF method was appropriate in the absence of a historical track record to substantiate the forecasts.
 - When applying the market approach to value a target company engaging in a novel or innovative industry, issuers should explain how the use of the market approach is appropriate in the absence of similar or comparable companies.

Where more than one valuation method is used, issuers should disclose the process in analysing the values derived from different valuation methods and how they contributed to the appraised value.



B. Valuation assumptions and inputs

1. Issuers should explain, with detail and in specific terms, their assumptions and adopted valuation inputs.
2. Where the valuation assumptions and/or inputs are significantly different from the historical information of target company/industry or the parameters of comparable companies, issuers should further substantiate the fairness and reasonableness for using the assumptions and/or inputs.

For example:

- In a DCF valuation where the projected revenue is premised on a significant growth over the historical trend of the target company and/or the projected profit margin is significantly higher than that of the target company's industry peers, the issuer should disclose details of the basis of projections and explain why such projections are fair and reasonable for the transaction or the target company.
- In a market approach valuation, the issuer should disclose the criteria and process for selecting comparable companies, and explain why the selected market comparables are appropriate in the circumstances. Where the multiples of comparable companies span across a wide range, the issuer should further explain the rationale for including or excluding any potential outliers, and the basis of deriving the multiple for the valuation (instead of, for instance, simply taking an average of the widely dispersed multiples of "comparable companies" with questionable comparability).

⁵ Main Board Rule 14.58(5) / GEM Rule 19.58(6).

HKEX's ongoing journey in application of technology

Regulators worldwide have been using Regtech increasingly in their regulatory activities. Keeping abreast of the latest technological innovations and trends, we have been strengthening our IT capabilities to enhance operational effectiveness and efficiency. We would like to share with you our IT journey, and how we have applied technology to our regulatory functions and daily operations.

Using AI technology in the review of issuers' documents

In 2020, we applied AI technology to vet issuers' annual reports. Our AI model JURA checked issuers' compliance with our disclosure requirements for annual reports. This extended the breadth and reach of our annual report review programme from strictly a thematic based review of selected issuers to a comprehensive review of all listed issuers' annual reports.

Last year, we extended JURA to review annual results announcements. JURA highlights red flags and potential non-compliances with the Rules that require immediate attention, for example, requiring an immediate trading suspension or clarification to the market. JURA also performs financial analysis and identifies material fluctuations, alerting our teams to areas requiring further review and follow up with listed issuers. This is particularly useful during the financial reporting peak season in March, where over 1,100 results announcements are generally issued within the last week of that month.

This year, JURA will review disclosures in issuers' ESG reports. JURA can review and identify non-disclosure by issuers of particular Rule requirements, and can extract disclosures from annual reports and ESG reports for further analysis, supporting HKEX's review of the quality of issuers' ESG disclosures.

We are continuing to use technology to vet issuers' documents. This year, we will expand our model to vet issuers' transaction and fundraising announcements.

Case management and workflow system

In April 2023, our case management and workflow system was expanded to all departments within the Listing Division, following its initial launch in 2020 for the Listed Issuer Regulation Department. Integrating with our other systems, this system offers a one-stop platform for us to handle our daily work and is equipped with a range of functions including auto-filing, e-signature tools, and template generation, etc. This system also provides real-time case statistics and analysis to allow managing case load and response to issuers.

With the onboarding of all departments in the Listing Division, information about an issuer, from its initial status as an IPO applicant to any enforcement investigations, is now readily accessible on the system to allow quick access of information to facilitate our regulation.



Under development: issuer platform

To enhance communication with listed issuers, we are planning a two way communication platform for issuers' submissions to HKEX and our replies and commenting through a secured channel. This is a one-stop channel for issuers to make private submissions on cases and filings of changes to corporate standing data and director information, and replaces the current emails and e-Forms. Corporate and director information filed on the platform can generate announcements that can be published on HKEX's news website, and populate an issuer database available to investors.

This platform will be scalable and over time, can provide issuers with value added tools such as compliance reminders and targeted guidance materials.

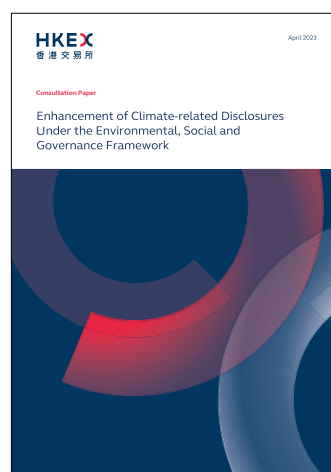
Publications

We have recently published or revised the following guidance materials:

- [Revised GL113-22](#) (9 December 2022) to provide guidance for special purpose acquisition companies with, or seeking, a listing on the Exchange.
- [Revised Listing e-Forms and Guidelines](#) (10 & 31 December 2022) relating to (i) announcements and trading arrangements, (ii) directors and supervisors, authorised representatives and company secretaries, (iii) blackout period, (iv) application for listing of securities, and (v) meeting notification.
- Updates and withdrawals of FAQs, Guidance Letters, Listing Decisions and checklists (30 December 2022) in relation to the Rule changes relating to share scheme of listed issuers.
- [FAQ No. 118-2023](#) (24 February 2023) relating to the impact on the issuance of securities by listed issuers in respect of the PRC's new filing requirements for overseas listings and securities offerings by Mainland companies.
- [Updates of Guide on General Meetings](#) (28 February 2023) to provide issuers with additional guidance on the holding of virtual or hybrid general meetings following the recent amendments to the Companies Ordinance for Hong Kong incorporated companies.
- [GL115-23](#) (30 March 2023) to provide guidance on Specialist Technology Companies with, or seeking, a listing on the Exchange.
- Revised disciplinary procedures of the [Listing Committee](#) and the [Listing Review Committee](#) (28 April 2023) relating to the arrangement of the Chairman of the Disciplinary Committee and the handling of potential conflicts of interest.
- [GL79-14](#) (5 May 2023) to provide guidance on the documentary requirements and administrative matters for listed collective investment schemes issuers.

We have also recently published:

- A consultation paper on [Enhancement of Climate-related Disclosures under the ESG Framework](#) (14 April 2023) to mandate all listed issuers to make climate-related disclosures in their ESG reports. The consultation period will be closed on 14 July 2023.
- A consultation conclusion on [Specialist Technology Companies](#) (24 March 2023) to create a listing regime for Specialist Technology Companies in Hong Kong. The new Rules take effect on 31 March 2023.



We welcome your feedback.

Please send your thoughts and comments to listingnewsletter@hkex.com.hk